No. 00-511

IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR RESPONDENTS WORLDCOM, INC., THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES, AND COMPETITIVE TELECOMMUNICATIONS ASSOCIATION

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QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioners state as follows:

WorldCom, Inc.

WorldCom, Inc., through its wholly-owned subsidiaries, provides local and long-distance telecommunications services domestically and internationally. WorldCom, Inc. is a publicly traded company on the Nasdaq National Market under the symbol "WCOM." No publicly held company owns 10 percent or more of WorldCom, Inc. stock.

The Association for Local Telecommunications Services

The Association for Local Telecommunications Services ("ALTS") is the national trade association representing facilities based providers of competitive local telecommunications services. ALTS has no parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.

Competitive Telecommunications Association

The Competitive Telecommunications Association ("CompTel") is a national industry trade association representing competitive telecommunications carriers and their suppliers. Its over 300 members include large nationwide suppliers as well as scores of smaller regional carriers. CompTel has not issued shares or debt securities to the public. CompTel does not have any parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.

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BRIEF FOR RESPONDENTS

For the past five decades, regulators, legislators, courts, and competitors have struggled to break open the Bell System's all-encompassing telecommunications monopoly. The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151-276 ("the 1996 Act" or "the Act"), is in many respects the culmination of those efforts. The Act's local competition provisions, 47 U.S.C. §§ 251-254, sought to bring competition to the market for local telephone service – the last bastion of the telephone monopoly, dominated now as then by the former Bell Operating Companies and GTE.[1] Specifically, Congress required these incumbent carriers to interconnect with, and lease unbundled parts of the local network to, competitors at "just and reasonable" rates. 47 U.S.C. §§ 251(c)(2), (c)(3). Concomitantly, the 1996 Act gave the incumbents access to many markets from which they had been previously barred, some immediately and others (such as in-region long distance) upon meeting appropriate conditions. *Id.* §§ 271-276.

While exploiting the enormous benefits the 1996 Act afforded them, and increasing their profits and stock values handsomely as a result, the incumbents have maintained a vigorous rear-guard action in the courts to protect their monopolies over local service. One principal focus of their attack has been the pricing methodologies established by the Federal Communications Commission (the "FCC" or the "Commission") for determining the rates at which the incumbents must make interconnection and unbundled network elements available to new competitors. In accordance with the weight of academic and expert commentary, and following the lead of progressive States that had sought to open their local

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[1]Through a series of mergers and combinations, the principal incumbents are now Verizon Communications Inc., BellSouth Corporation, SBC Communications Inc., and Qwest Communications International, Inc.

markets even before passage of the 1996 Act, the FCC adopted a forward-looking cost methodology called TELRIC ("Total Element Long-Run Incremental Cost") for setting these rates. The FCC determined that a forward-looking methodology – which determines what it would cost to provide interconnection or an unbundled element efficiently today – was the approach best suited to fostering local competition.

As the incumbents would have it, the FCC's policy choice not only violated the plain terms of the 1996 Act but also constituted a radical and dangerous break with the modern consensus that utility rates must be set on the basis of the historical costs reflected on the utilities' books of account. More jeremiad than legal argument, the incumbents' brief resounds with dire warnings that TELRIC will confiscate billions of dollars of wealth in defiance of the Constitution's guarantee of just compensation.

None of that is true. Putting aside the incumbents' implausible argument that the text of the 1996 Act mandates a historical cost methodology for setting these rates, there is a short and sufficient answer to all of the incumbents' constitutional claims: the incumbents did not present the FCC with a shred of evidence to support them. The claims incumbents make here are instead a pastiche of unsupported extra record assertions, bald conjecture, and self-serving citations to their own submissions in other proceedings – submissions that were often rejected out of hand by the regulatory authorities. Thus, this Court could not accept the incumbents' claims without doing violence to both established Takings jurisprudence (which requires a showing of confiscatory effect and forbids purely methodological challenges) and established administrative law doctrine (which requires those who challenge agency orders to make their case first at the agency). In any event, if this Court were to look beyond the record it would discover in short order why the

incumbents have substituted overheated rhetoric for empirical analysis. In the five years since TELRIC was adopted, new competitors have managed to obtain only 3% of local customers nationwide using unbundled elements. The notion that the FCC "[w]ith a stroke of the regulatory pen" (ILEC Br. at 1) stranded billions of dollars in investment is thus farcical.

If this Court looks beyond these patent deficiencies and considers the incumbents' methodological challenges on the merits, it should reject them. The incumbents can prevail only if this Court overrules *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"), and *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), and holds that the Fifth Amendment requires regulators to use historical cost methods to set utility rates. But *Hope* and *Duquesne* reflect hard-won wisdom about the Court's institutional limitations as an economic policymaker, and they give state and federal authorities needed room to make the practical assessments and pragmatic adjustments that good public policy requires. This Court should not overrule them.

COUNTERSTATEMENT

The 1996 Act and the FCC's implementation of it were not bolts from the blue as the incumbents suggest, but rather were the logical outgrowth of five decades of steady efforts to introduce competition in all markets for telephone service.

A. The Bell System Monopoly and the Onset of Competition

Originally, the incumbents (apart from GTE) were part of the integrated Bell System, which held monopolies on local telephone service throughout the country. The incumbents were affiliated with AT&T, which monopolized the long distance market, and Western Electric, which monopolized the business of manufacturing telecommunications equipment. The Bell System's dominance rested on its control of local

networks. Each local network consisted of lines and switches that connected all homes and businesses in an incumbent's local service area. That network was used to provide local service, but it was also indispensable to long distance service.

Regulatory authority over the telephone system was divided between the federal government (which regulated interstate service) and state governments (which regulated intrastate service). 47 U.S.C. § 152. For years, state governments were generally content to superintend a traditional monopoly rate-of-return regime in local markets. Because local service was thought to be a "natural monopoly," the incumbents were given exclusive franchises, and the rates they charged for service were set by state utility commissions using traditional cost-of-service ratemaking methods. To promote "universal service," the incumbents were permitted to charge highly inflated rates to some customers (chiefly businesses and urban residents) and for some services (such as call-waiting), purportedly because subsidies were needed to provide basic service to high cost (chiefly rural) customers at affordable rates.

The federal government charted a different course. Beginning in the 1960s, the FCC took steps to introduce competition into the markets for customer premises equipment and long distance service.[2] After MCI and other competitors received the right to use the Bell System's local network to initiate and terminate long distance calls (to "interconnect" with the network),[3] competition in the long distance industry began to take hold. Similarly, by the mid-1970s the FCC had rejected AT&T's position that only AT&T customer equipment could

[2] *See MCI Telecommunications Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977).

[3] *See MCI Telecommunications Corp. v. FCC*, 580 F.2d 590 (D.C. Cir 1978); *Lincoln Tel. & Tel. Co. v. FCC*, 659 F.2d 1092 (D.C. Cir. 1981).

be used on AT&T's network, opening the equipment market to competition as well. *See Litton Sys., Inc. v. American Tel. & Tel. Co.*, 700 F.2d 785 (2d Cir. 1983).

The incumbents strenuously resisted the introduction of these forms of competition through a variety of means. That conduct led to the government's antitrust case against AT&T, which was resolved by a 1982 consent decree that divested the incumbents from AT&T. *See United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983). The decree prohibited incumbents from entering the markets for long distance telephone services, equipment manufacturing, information services, and any nonregulated services lest incumbents use their monopoly control over the local network to thwart competition in these related markets. Competition soon flourished in the markets from which the incumbents were barred.

B. The Move Toward Local Competition

These successes led policymakers to question the assumption that local service should be kept immune from competition. Congress held hearings in the late 1980s and early 1990s on proposals to restructure telecommunications markets, emphasizing the need to "rid ourselves of our blind spot to the notion that real competition could never come about in the local exchange arena," and noting that European regulators were already experimenting with local competition.[4]

[4] *Modified Final Judgment: Hearings on H.R. 1523 Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 100th Cong. 32 (July 11, 1991) (statement of Rep. Dan Schaefer); *see also Telecommunications Policy Act (Part 2): Hearings Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 101st Cong. 42 (May 10, 1990) (statement of Albert H. Kramer) ("The lesson of the last two decades is that

While this policy question was being debated in Congress, several progressive States moved forward with efforts to introduce competition to local markets. Regulators in California, Florida, Michigan, Oregon, and Texas, for example, eliminated monopoly franchises and imposed interconnection and unbundling requirements on incumbents as a matter of state law. *See infra* at 18-19 & nn.12, 14.

C. The 1996 Act

Building on these efforts, Congress sought in the 1996 Act to restructure the telecommunications industry in order to "open[] *all* telecommunications markets to competition." H.R. Conf. Rep. No. 104-458, at 1 (1996) (emphasis added). Congress thus preempted state monopoly franchise laws and similar legal barriers to local competition. 47 U.S.C. § 253. In recognition that the costs of competitive entry were enormous, and following the lead of state commissions, Congress offered three complementary routes to local competition. Under § 251(c), a would-be competitor "can purchase local telephone service at wholesale rates for resale to end users; it can lease elements of the incumbent's network 'on an unbundled basis'; and it can interconnect its own facilities with the incumbent's network." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). Congress also mandated reform of the prior "universal service" system of implicit cross-subsidies, requiring both the FCC (for interstate rates) and the States (for local and other intrastate rates) to ensure affordable service through a system

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the best way to deliver new services and lower prices to consumers is to break up monopoly power."); *AT&T Consent Decree: Hearings Before the House Subcomm. on Economic and Commercial Law of the Comm. on the Judiciary*, 101st Cong. 749 (Aug. 1-2, 1989) (letter dated August 21, 1989, from Terence Roche Murphy, counsel to British Telecommunications plc) (noting that "the U.K. has sanctioned local loop competition").

of explicit subsidies that is compatible with the introduction of competition. 47 U.S.C. § 254.

The 1996 Act, however, did not express a preference for any particular type of competition. *See In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499, ¶ 12 (1996) ("*Local Competition Order*") ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.") (JA 271-72). Congress saw that competition had developed in the long distance market through a combination of resale and facilities-based competition, and it was willing to let competitors, rather than legislators or incumbents, determine the best strategy for competition. *See id.* Congress thus "reasonably omitted a facilities-ownership requirement" from the 1996 Act. *AT&T*, 525 U.S. at 392-93.

One critical task Congress delegated to the FCC was the decision of how rates for interconnection and access to unbundled network elements were to be determined. *Id.* at 382-83. The Act simply requires that rates for interconnection and leasing of network elements be "just and reasonable" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)." 47 U.S.C. §§ 251(c)(2), (c)(3), and 252(d)(1). The FCC was charged with implementing these and other requirements of the Act within six months of its passage. *Id.* § 251(d)(1). Once the FCC had established rules, individual state utility commissions would apply them (in light of their superior knowledge of local conditions) to establish "interconnection agreements" between new entrants and incumbents for use of the local network. *Id.* § 252.

The 1996 Act also provided significant benefits to incumbents. Not only did Congress terminate the AT&T consent decree, *see* Pub. L. No. 104-104, 110 Stat. 56, § 601,

it authorized immediate entry by the incumbents into important segments of the long-distance market that had been previously blocked off by the decree. *See, e.g.*, 47 U.S.C. § 271(b)(2) (out-of-region long distance service); *id.* § 271(b)(3) ("incidental interLATA services" such as commercial mobile services (*e.g.*, cellular)). Most importantly, the Act authorized lifting restrictions on the incumbents' provision of in-region long-distance services once the incumbent had satisfied a "competitive checklist." *See id.* § 271(c). Foremost among the checklist requirements are the incumbents' obligations to offer interconnection and nondiscriminatory access to network elements in accordance with the pricing requirements of the local competition provisions.

D. The FCC's Implementation of the 1996 Act

In the *Local Competition Order* issued in August 1996, the FCC concluded that the rates new competitors pay for interconnection and unbundled network elements should be based on "forward-looking long-run economic cost" rather than on "historical" or "embedded" cost. After concluding that the 1996 Act did not dictate the use of any particular methodology, *Local Competition Order* ¶ 705 (JA 398-99), the FCC determined, based on the "substantial weight of economic commentary in the record," that a forward-looking methodology better serves the Act's principal goal of fostering local competition. That was so *not* because a forward-looking methodology would produce lower rates. To the contrary, forward-looking cost "may be higher or lower than historical embedded cost." *Id.* Rather, as the FCC concluded, "a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace." *Id.* ¶ 679 (JA 379-80). Accordingly, such a methodology "will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act," *id.* ¶ 705 (JA 398-99), and

should "drive retail prices to their competitive levels." *Id.* ¶ 679 (JA 379-80).

The FCC's approach – called "Total Element Long-Run Incremental Cost" or "TELRIC" – calculates the rate for network elements on the basis of what it would cost to provide the functions the element provides efficiently using up-to-date technology. As the FCC noted, such methods had gained wide acceptance in the professional literature and had been implemented by regulators prior to the 1996 Act both here and abroad. *See id.* ¶ 631 & nn.1508-14 (JA 334-36); *id.* ¶ 681 ("A number of states . . . have already implemented forward-looking incremental costing methodologies to set prices for interconnection and unbundled network elements . . . .") (JA 381).[5] Indeed, several States urged the FCC to adopt a forward-looking cost approach, and none advocated an approach based on historical costs. *Id.* ¶ 671 n.1675 (JA 374).

The FCC also noted that TELRIC – through adjustments in depreciation schedules and the cost of capital – addressed directly the incumbents' concerns that declining technology costs and increased competition could affect the value of their network. *See, e.g.*, *id.* ¶ 686 ("properly designed depreciation schedules should account for expected declines in the value of capital goods" due to "declining technical costs and competitive entry") (JA 384-85); *id.* ¶ 702 ("the overall increases in competition in this industry" "might warrant an increased cost of capital") (JA 395-96). The FCC did not, however, prescribe any particular depreciation schedule or cost of capital. Instead, it left those matters to the States. *See id.* ¶ 29 (JA 273-74).

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[5] *See* Commission of the European Communities, Commission Recommendation on Interconnection in a Liberalised Telecommunications Market, Oct. 15, 1997, http://www.ispo.cec.be/infosoc/telecompolicy/en/r3148-en.htm (noting that England, Australia, Denmark, and Sweden have adopted forward-looking rates).

The FCC also considered objections to TELRIC based on the Just Compensation Clause of the Fifth Amendment. It noted that if § 251(c)'s interconnection and unbundling requirements were deemed to be a physical occupation of the incumbents' property, TELRIC would be constitutional because TELRIC provides compensation for "the fair market value of the property subject to the taking." *Id.* ¶ 740 (JA 422-23). Alternatively, applying the usual Fifth Amendment test in ratemaking cases, the FCC concluded that TELRIC "should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings," and that TELRIC thus enabled incumbents "to recover a fair return on their investment." *Id.* ¶ 738 (JA 421-22). The FCC further noted that no incumbent had produced any evidence that TELRIC prices "would have a significant impact on its 'fiscal integrity.'" *Id.* Finally, the FCC concluded that "[t]he record . . . does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at economic costs." *Id.* ¶ 707 (JA 400-01). The FCC made clear, however, that "[i]ncumbent LECs may seek relief . . . if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* ¶ 739 (JA 422).

E. Judicial Review

On review, the Eighth Circuit rejected the incumbents' arguments that the text of § 252(d)(1) of the 1996 Act and the Fifth Amendment required the FCC to use historical costs to set rates for interconnection and unbundled elements. Applying *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Eighth Circuit then held that the FCC's decision to interpret "cost" as meaning "forward-looking cost" was reasonable, because "[f]orward-looking costs have

been recognized as promoting a competitive environment which is one of the stated purposes of the Act." WorldCom Pet. App. 9a-10a. The court also noted that the FCC had "explained in detail" its reason for selecting a forward-looking cost methodology and had sufficiently explained "any past rejection of forward-looking methodologies." *Id.* With respect to the Fifth Amendment, the Eighth Circuit followed this Court's teaching that "a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *Id.* at 13a. Because no "actual rates are established," the court held that it could not determine "whether the impact of TELRIC driven rates will constitute a taking." *Id.* at 13a-14a. Finally, citing *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29 (1985), the court held that "constitutional avoidance" did not require a different conclusion, because "[t]he possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction," and instead merely "frustrate[s] a potentially permissible application of a statute." WorldCom Pet. App.14a.[6]

F. Local Competition Since the 1996 Act

Despite the efforts of Congress, the FCC, and the States, the incumbents currently control almost 92% of local customers nationwide. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 1 (May 2001). Moreover, despite the alleged "massive price reductions" (ILEC Br. at 10) resulting from the FCC's TELRIC methodology, only approximately 3% of local phone

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[6]The Eighth Circuit invalidated one aspect of TELRIC – specifically, the requirement that forward-looking costs be calculated on the basis of the efficient replacement cost of a network element rather than on the cost of the actual network element being used. That ruling is at issue in the related matters of 00-555, 00-587, 00-590, and 00-602.

service is provided using leased unbundled elements. *See id.* at Table 4. The incumbents themselves have been particularly slow to exploit this supposed gold mine. Efforts on their part to compete in each other's local markets are negligible. Meanwhile, long distance authority under § 271 has been granted to incumbents in five States – New York, Texas, Oklahoma, Kansas, and Massachusetts – and more applications are expected soon.[7] Verizon already claims to be the fourth largest long distance company nationwide.

The incumbents have thrived under the 1996 Act. The combined rate of return for their regulated business (state and interstate) has risen from 11.2 percent in 1996 to 16.5 percent in 2000.[8] Their stock value has appreciated substantially, while the value of their principal competitors has stayed flat or eroded.[9] Reality thus refutes the incumbents' unsubstantiated assertions that their investors have suffered "egregious" losses as a result of the FCC's "harsh" regulatory regime. ILEC Br. at 29-30.

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[7] *See* Communications Daily, at 7 (May 4, 2001) (reporting that Verizon expects to file applications with the FCC to provide long distance service in six States by the end of 2001, with another four in 2002). An application for long distance authority in Connecticut is pending at the FCC.

[8] *See* http://gullfoss2.fcc.gov/cgi-bin/websql/prod/ccb/armis1/forms/armis.hts>> (Report 43-01) (ARMIS data).

[9] Adjusted for splits, BellSouth stock was trading at $19.11 per share on August 8, 1996 (when the FCC released its *Local Competition Order*), and was trading on June 1, 2001, at $40.56 per share. Over the same time period, SBC went from $22.12 to $42.05, and GTE/Verizon went from $25.82 to $54.74. In contrast, Sprint went from $15.68 in August 1996 to $20.96 on June 1, 2001, while AT&T went from $36.39 to $21.49 and WorldCom went from $17.50 to $18.07. *See* <<http://chart.yahoo.com/d>> (providing split-adjusted historical stock data).

SUMMARY OF ARGUMENT

The incumbents' attacks on the FCC's TELRIC methodology lack any merit. Indeed, the incumbents do nothing more than recast as statutory and constitutional claims the failed policy arguments they have been pressing for years before the FCC and state utility commissions.

1. There is no basis in the text, structure, or purposes of the 1996 Act for the incumbents' argument that Congress forbade the FCC from prescribing a forward-looking cost methodology such as TELRIC to calculate the rates new entrants must pay to interconnect with, or lease elements of, the local network. Far from imposing "clear limits" on the FCC's authority, the text of § 252(d)(1) delegates broad methodological leeway. *AT&T*, 525 U.S. at 397. The term "based on . . . cost" has no single fixed meaning, and in the ratemaking context can as easily mean "forward-looking cost" as "historical cost." Indeed, regulators routinely base rates on forward-looking costs, and uniformly did so to implement state market-opening initiatives that presaged the 1996 Act. Section 252's indication that rates "may include a reasonable profit" provides incumbents no support because TELRIC expressly provides for a reasonable profit. Thus, the incumbents have no argument that "Congress has addressed the precise question at issue" and unambiguously foreclosed the FCC's choice of TELRIC. *See Chevron*, 467 U.S. at 843.

2. The Just Compensation Clause of the Fifth Amendment does not bar TELRIC, either directly or as a matter of constitutional avoidance. Since *FPC v. Hope Natural Gas Co.*, the Just Compensation Clause has not bound regulators "to the use of any single formula or combination of formulae in determining rates," and requires only that the end result of applying a rate methodology not be confiscatory. 320 U.S. at 591. Those principles should not be discarded.

Indeed, the FCC's choice of TELRIC should be upheld without any consideration of the incumbents' radical proposal for rewriting Takings law. Even on its own terms, the incumbents' case depends entirely on the factual allegation that TELRIC will result in a massive under-recovery of historical costs still on the incumbents' books. The FCC specifically found, however, that the "record does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at TELRIC rates," *Local Competition Order* ¶ 707 (JA 400-01), and the incumbents can point to nothing in the record refuting that finding. In all events, the FCC has made clear that an incumbent may seek individualized relief in a separate proceeding if it can demonstrate significant unrecoverable costs. *Id.* ¶ 739 (JA 422). And the incumbents cannot prevail under existing law because they have not shown that TELRIC will impair their ability to "maintain . . . financial integrity, to attract capital, and to compensate its investors for the risk assumed." *Hope*, 326 U.S. at 605. This Court need go no further to dispose of the incumbents' claims.

If this Court considers the incumbents' methodological challenges, it should reject them. The incumbents assert that the Just Compensation Clause forbids a "switch in methodologies unaccompanied by some mechanism to compensate for investment stranded by the shift . . ." ILEC Br. at 27. But there has been no "switch." Rather, Congress imposed, and the FCC implemented, an entirely new set of obligations at the wholesale level to promote competition. In any event, the law forecloses incumbents' argument. *Duquesne* expressly upheld a methodological change that resulted in nonrecovery of prudently incurred costs. 488 U.S. at 315. Such a rule is not needed to protect reasonable investor expectations. No investor has a reasonable expectation that rate-setting methodologies will not change in ways that leave

the investor worse off. And no reasonable investor in the past decade could have believed that the incumbents would remain insulated from competition. Finally, this Court should not make prudently incurred historical costs the sole constitutional standard for rate-setting. That standard is neither more practical nor more fair than available alternatives, including forward-looking methodologies such as TELRIC. A decision to enshrine prudently incurred historical costs would be "as unwarranted as it would be unsettling," *Duquesne*, 488 U.S. at 315, for it would deprive state and federal policymakers of the flexibility needed to "devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Id.* at 313-14 (quotation omitted).

3. The FCC's decision to adopt TELRIC was well "within the bounds of the reasonable," *AT&T*, 525 U.S. at 395, and thus raises no substantial issue under the Administrative Procedure Act. 5 U.S.C. § 706. The *Local Competition Order* contains 244 paragraphs carefully elucidating the FCC's reasoning, and detailing why the FCC declined to adopt the other available options. The FCC likewise persuasively explained why TELRIC would not skew the competitive process or deter competitors from constructing their own facilities where appropriate.

ARGUMENT

I. THE 1996 ACT DOES NOT MANDATE RATES BASED ON THE INCUMBENTS' HISTORICAL COSTS.

Sections 251(c) and 252(d) provide ample authority for the FCC's decision to adopt TELRIC. As previously demonstrated, those provisions contain no mandate that the rates new entrants pay to use the existing local network be based on the incumbents' historical costs. *See* Brief for Petitioners WorldCom, Inc., *et al.* No. 00-555 at 23-27 ("WorldCom Br.").

To the contrary, the 1996 Act delegates to the FCC broad authority to establish a rate-setting methodology that will advance the Act's goal of transforming the monopoly rate-of-return regime for local telephone service into a competitive market. *See AT&T*, 525 U.S. at 397; *id.* at 423 (opinion of Breyer, J.) (Act confers "'broad methodological leeway,'" and "say[s] little about the 'method employed' to determine a particular rate."). Indeed, the only way to grant what the incumbents demand – a guaranteed return on their embedded or historical rate base – would be to engage in the one thing § 252 forbids: a "rate-of-return or other rate-based proceeding." 47 U.S.C. § 252(d)(1)(A). *See GTE South, Inc. v. Morrison*, 6 F. Supp. 2d 517, 529 (E.D. Va. 1998) ("Historical costs are determined in a rate-of-return or other rate based proceeding. . . . Therefore, they are excluded by § 252(d)(1)(A)."), *aff'd*, 199 F.3d 733 (4th Cir. 1999).

Ignoring § 252(d)(1)(A), the incumbents rest their claim for traditional historical cost ratemaking on alternative (and contradictory) readings of the phrase "based on . . . . cost" in § 252(d)(1). They first advance a plain meaning argument, contending that "cost" has a single fixed meaning understood by all to be historical costs. But that argument is not plausible. *See* WorldCom Br. at 25-26; *see also* Ralph Estes, *Dictionary of Accounting* 32 (2d ed. 1985) (term "cost" is "virtually meaningless without an indication of the type of cost, such as incremental cost, variable cost, fixed cost, replacement cost or historical cost"). The incumbents thus beat a quick retreat to the argument that the term "cost" has come to acquire the specialized meaning of "historical cost" in the rate-setting context. Although the incumbents are correct that technical terms should be interpreted "by reference to the art or science to which they [are] appropriate," *Corning Glass Works v. Brennan*, 417 U.S. 188, 201 (1974) (internal citation and

quotation omitted), their assertion that "cost" in this context inevitably means "historical cost" is wrong.

"Historical cost" is one accepted meaning of the term cost in rate-setting, but it is by no means the only accepted meaning. Indeed, incumbents' own experts conceded that the very provision at issue here "does not establish whether the rates for unbundled services and interconnection should be based on actual embedded costs, LRIC, or TSLRIC (total-service long-run incremental cost)," and that "[f]rom an economic standpoint, the pricing of any network function . . . should be based on *long-run incremental cost*."[10] More broadly, regulators often set rates by reference to measures other than historical cost – and the consensus that historical cost methods should not be used is increasing. That point is vividly confirmed by the incumbents themselves, who have "strongly support[ed]" prices for interconnection "based on forward-looking long-run incremental costs" abroad, where they seek to compete in local markets.[11]

At the federal level, the Interstate Commerce Commission and the Surface Transportation Board specifically relied on forward-looking cost measures to set the rates railroads can charge captive shippers. *See Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 (1985); *Consolidated Rail Corp. v. United States*,

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[10]Affidavit of Dr. Robert Crandall ¶¶ 10, 14 (attached to Bell Atlantic Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) (emphasis added) (JA 84-86); *see also* Affidavit of Edward C. Beauvois, Ph.D, at 2 (attached to GTE Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) ("[e]conomic theory is absolutely clear that the relevant costs to look at in making pricing decisions are incremental costs") (JA 104).

[11]U S West, A Framework for Effective Competition, at 15; *see also* Submission by Ameritech International, Inc. and Bell Atlantic International, Inc. ¶¶ 1.1-1.2 (endorsing an incremental approach over "historical cost" pricing).

812 F.2d 1444, 1453-57 (3d Cir. 1987); *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 194-95 (D.C. Cir. 1984). The "area rate" method adopted by the Federal Power Commission almost 40 years ago (and repeatedly upheld by this Court) explicitly departed from traditional historical cost methods. *See Wisconsin v. FPC*, 373 U.S. 294, 307-10 (1963). States have likewise turned away from historical cost approaches with increasing frequency.[12]

Ironically, States have been most aggressive about eschewing historical cost methods in precisely the area most relevant here – implementing the state-law precursors to the 1996 Act. States requiring incumbents to unbundle the local network *have uniformly based unbundled element rates on forward-looking, long-run incremental costs*.[13] Thus, for

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[12]*E.g.*, Rules Prescribing Principles for Costing and Pricing of Regulated Services of Telecommunications Providers, 4 Code of Colorado Regulations § 723-30 (requiring carriers to provide "total service long run incremental cost studies" for both fully regulated services and emerging competitive services); *Implementation of Section 13-507 of the Public Utilities Act, as amended by P.A. 87-856*, Docket No. 92-0211, 155 P.U.R. 4th 188 (Ill. Comm. Comm'n. Aug. 17, 1994) (adopting "long run service incremental cost" methodology for, among others, formerly non-competitive services which have become or are becoming competitive); Mich. Comp. Laws § 484.2202(a) (requiring carriers to measure and report their "total service long run incremental costs"); *see also id.* §§ 484.2352, 484.2357; *In re On the Commission's Own Motion to Determine the TSLRIC and Imputation Requirements Under the Michigan Telecommunications Act*, Case No. U-11103 (Mich. Comm'n Dec. 12, 1996); Tex. Util. Code Ann. §§ 51.002, 52.0583, 52.0584, 52.204, 57.022, 58.055 (mandating the use of long-run incremental cost studies for pricing various competitive services).

[13]Similarly, during the over two–year period in which the FCC's TELRIC rules were not in effect, at least thirty-five state commissions implementing the Act unanimously stated that they were adopting forward-looking cost methodologies that were the same as, or similar to, the FCC's TELRIC methodology. *See* David Gabel & David I. Rosenbaum, *Who's*

example, the consensus cost principles adopted by carriers in California – including the incumbent Pacific Bell – used a total service long-run incremental cost measure. Florida similarly adopted a total service long-run incremental cost measure to price unbundled network elements, as did Oregon, Texas, and Michigan.[14] The incumbents' reading of § 252(d)(1) would therefore result in federal preemption of the state market-opening initiatives on which the 1996 Act was modeled. That cannot be what Congress intended.

The incumbents' remaining statutory construction arguments are makeweights. Specifically, Congress' suggestion that rates "may include a reasonable profit," § 252(d)(1)(B), does not mandate historical cost rate-setting. As the FCC recognized, "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." *Local Competition Order* ¶ 700 (JA 393-95); *see also Burlington N. R.R. Co. v. Surface Transp. Bd.*, 114 F.3d 206, 210, 212-14 (D.C. Cir. 1997) (rates based on forward-looking costs of "hypothetical 'stand-alone railroad'" provide "a competitive return on all investments the

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Taking Whom?, 52 Fed. Comm. L.J. 239, 245 (2000).

[14]*See* Consensus Costing Principles/Basic Network Function; OANAD Cost Methodology Workshops, *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework of Network Architecture Development of Dominant Carrier Networks*, No. R-93-04-003 (Cal. Pub. Utils. Comm'n Aug. 23, 1995); *In re Resolution of Petition(s) to Establish Nondiscriminatory Rates, Terms, and Conditions*, Order, Docket No. 950984-TP, 1996 WL 369405 (Fla. Pub. Serv. Comm'n June 24, 1996); *In re Investigation into the Cost of Providing Telecommunications Services*, UM 351, Order No. 93-1118 (Or. Pub. Util. Comm'n Aug. 10, 1993); *Substantive Rules of the Public Utility Comm'n of Texas* § 23.91(f); *see also supra* at 18 & n.12 (Michigan).

railroad actually made at their current value"). The "cost of obtaining debt and equity financing" is the economic definition of a normal profit. *See Local Competition Order* ¶ 700 (citing *MIT Dictionary of Modern Economics* at 310 (4th ed. 1992)) (JA 393-95). Although the incumbents focus on an accounting measure of profit, § 252(d)(1)(B) is far better read as allowing for "profit" in the sense in which that term is usually used in the rate-setting context – *i.e.*, economic profit. *See MIT Dictionary of Modern Economics* at 350 (definition of profit) (cost of capital is "not included as cost[] in the accountants' measure of profit which therefore does not correspond to this economic definition of profit"). If Congress had intended to require historical cost ratemaking, it could hardly have found a less direct way to do so than by the inclusion of a profit allowance in § 252(d)(1)(B).

Nor can the incumbents find support in § 251(d)(1)'s command that the FCC "complete all actions necessary within six months." As the incumbents would have it, applying an approach such as TELRIC within that time-frame would not be possible, and Congress must therefore have intended that rates be based on historical cost models. That argument suffers from a basic confusion. Congress required that the FCC "establish regulations to implement" the 1996 Act within six months, § 251(d)(1), and the FCC did so. Congress did not, however, mandate application of those regulations to generate specific rates within that time. Indeed, the arbitration process contemplated in § 252 (which takes several months) could not even have commenced until after the regulations were promulgated. 47 U.S.C. § 252(b)(2)(C).

Moreover, the use of historical costs (rather than TELRIC) to set rates under the 1996 Act would have been much more difficult and much more likely to produce delay, for two reasons. First, for more than a decade, the States and the FCC have used price caps – not historical costs – to set the rates the

incumbents may charge. *See* WorldCom Br. at 8. Thus, historical costs are not "already established" (ILEC Br. at 22), and would have to be calculated from scratch. Second, far from being "readily available" (ILEC Br. at 22), the historical costs associated with network elements cannot be ascertained by reviewing the incumbents' books because they do not allocate costs to particular categories of network elements. *See* WorldCom Br. at 36-37 & n.11; *infra* at 44-45. Economic modeling at least as complex as that needed to implement TELRIC would thus be required to determine appropriate allocations of the incumbents' book costs to the individual elements that make up the network. In contrast, the adoption of TELRIC minimized the need for drastic changes by regulators, particularly in States that had already implemented unbundling regimes prior to adoption of the *Local Competition Order*.

Nor do the Act's resale provisions, §§ 251(c)(4) and 252(d)(3), support the incumbents' statutory argument. The incumbents' position is that because Congress allows them to recover their historical costs when they sell services to new entrants at wholesale rates, it must have intended for them to recover their historical costs when they lease network elements. Given that the incumbents elsewhere in their brief complain bitterly that retail rates are often *below* cost, they can hardly argue in this context that the Act's resale provisions (which by definition provide for wholesale rates lower than those retail rates) ensure recovery of their costs.

II. THE JUST COMPENSATION CLAUSE PROVIDES NO REASON TO INVALIDATE THE FCC'S CHOICE OF TELRIC.

The incumbents impermissibly seek to convert a public policy debate over implementation of the 1996 Act into a matter of constitutional principle, and to rewrite constitutional law to enshrine their policy preference. Specifically, they

demand from this Court what they were unable to obtain from Congress, the FCC, and the States: a rule requiring that the rates charged for interconnection and leasing network elements be based on the historical costs on their books of account. The Court has rejected every previous effort in the last six decades to enshrine a particular ratemaking methodology as a constitutional requirement, and it should do so here as well.

A single fundamental premise guides this Court's ratemaking jurisprudence: the Just Compensation Clause does not bind regulators "to the use of any single formula or combination of formulae in determining rates." *Hope*, 320 U.S. at 602; *see also Duquesne*, 488 U.S. at 316 ("the adoption of single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since [*Hope*]"). As the Chief Justice noted in *Duquesne*, ""to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates."" 488 U.S. at 316 (quoting *Wisconsin v. FPC*, 373 U.S. at 309); *see also Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Cos.*, 498 U.S. 211 (1991); *FPC v. Texaco, Inc.*, 417 U.S. 380, 388 (1974).

Hope and *Duquesne* are grounded in principles of federalism, judicial restraint, and respect for the limits of judicial competence. Recognizing, for example, that "[t]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result," *Duquesne*, 488 U.S. at 314; *see also Permian Basin Rate Cases*, 390 U.S. 747, 790 (1968) ("neither law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders"), these cases ensure that the Court is not entangled in abstract and evolving debates over economic

theory. *See, e.g., CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 92 (1987) ("The Constitution does not require the States to subscribe to any particular economic theory.").

These decisions also acknowledge that politically accountable policymakers (state and federal) are far better suited than are Article III judges to make the judgments necessary for effective ratemaking. The cases thus allow for the "pragmatic adjustments which may be called for by particular circumstances," *Permian Basin Rate Cases*, 390 U.S. at 800, and they give States and federal agencies the necessary freedom to ""devise methods of regulation capable of equitably reconciling diverse and conflicting interests."" *Duquesne*, 488 U.S. at 313-14 (quoting *Permian Basin 390 U.S. at 767*). "[C]ircumstances may favor the use of one ratemaking procedure over another," and the imposition of a rigid constitutional requirement "would unnecessarily foreclose alternatives which could benefit both consumers and investors." *Id.* at 316. For that reason, regulators remain free "within broad limits" to decide "what rate-setting methodology best meets their needs in balancing the interests of the utility and the public." *Id.* So long as the total effect of the rate allows the company "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed," it is constitutional. *Hope,* 320 U.S. at 605; *see also Duquesne*, 488 U.S. at 312.

Against this backdrop, the radical character of the incumbents' position emerges in sharp relief. Although they focus their attack on the FCC's purported "switch" from a historical cost to a forward-looking cost approach, the incumbents' bottom line is that – one way or another – the FCC must compensate them for all prudently incurred costs on their books. That position could not be adopted without overruling *Hope* and *Duquesne*. Each of those cases approved a switch in methodology and explicitly rejected the view that the

Constitution requires a prudent cost methodology or, indeed, any particular methodology, in setting rates.

The incumbents have not remotely made the showing needed to justify such a sharp break with settled law. Indeed, this Court should reject the incumbents' arguments without reaching any fundamental questions of principle because their attack is based on a record entirely devoid of any actual rates, historical costs, or any other relevant evidence on the practical effect of the FCC's TELRIC methodology. Incumbents thus would not prevail even under the standard they propose. Similarly, incumbents cannot prevail under the total effects standard set forth in *Hope* because they have made no showing that the FCC's adoption of TELRIC as a standard for pricing interconnection and leased network elements will threaten their ability to attract capital and operate successfully.

If the Court nevertheless considers the incumbents' attacks on *Hope* and *Duquesne*, it should reject them. As the Court stated unambiguously in *Duquesne*, enshrining historical costs as the constitutional benchmark "would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling." 488 U.S. at 315. State and federal regulators have relied on that unbroken line of precedent in restructuring a host of regulated industries. *See, e.g.*, *City of Boerne v. Flores*, 521 U.S. 507, 536 (1997) ("When the political branches of the Government act against the background of a judicial interpretation of the Constitution already issued, it must be understood that in later cases and controversies the Court will treat its precedents with the respect due them under settled principles, including *stare decisis*, and contrary expectations must be disappointed."). The incumbents' distorted calculus of investor interests and their outdated evaluation of the strengths and weaknesses of competing methodologies provide no basis to depart from *Hope*'s well-worn path.

A. Incumbents' Constitutional Claim Fails on Its Own Terms.

The core of incumbents' Takings claim is that TELRIC will fail to compensate them for all the prudently incurred historical costs associated with the network elements they must lease to new competitors, thereby rendering those costs "stranded" or unrecoverable. According to incumbents, the Fifth Amendment forbids that outcome. As will be shown *infra*, the incumbents' legal position is refuted by a half-century of Takings jurisprudence. But it can and should be rejected for even more basic reasons. As this Court has noted repeatedly, agency ratemaking comes to this Court with a strong presumption of validity, and it is the incumbents' responsibility to put in evidence sufficient to overcome this presumption. *See, e.g.*, *Hope*, 320 U.S. at 602. Moreover, because this case involves review of an FCC administrative proceeding, any evidence on which the incumbents wished to rely had to be submitted to the FCC in the first instance. *See Center for Auto Safety v. Dole*, 828 F.2d 799, 810 (D.C. Cir. 1987) ("The reviewing court may not consider new evidence that was not before the agency when it made its decision.") (citing *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 744 (1985)). The incumbents have utterly failed to satisfy those requirements. In any event, the incumbents could not prevail even under their own theory because TELRIC is accompanied by an administrative "mechanism to compensate"(ILEC Br. at 27) incumbents on an individualized basis if appropriate.

1. There is no basis in the record for the incumbents' Takings arguments.

It is not true as a matter of logic that TELRIC rates for network elements will inevitably be lower than rates based on historical costs. Forward-looking rates can be higher or lower than historical cost rates, as numerous court decisions attest.

See, e.g., *Hope*, 320 U.S. at 596-97; *City of Los Angeles Dep't of Airports v. United States Dep't of Transp.*, 103 F.3d 1027, 1031-32 (D.C. Cir. 1997); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 299-300 (1923). In theory, there should not be much difference between the two. *See* Stephen Breyer, *Regulation and its Reform*, 37 (1982) (all methods of ratemaking seek to "replicate" the "price, profit, output and efficiency levels that would exist were the regulated market in fact competitive and well-functioning"). Thus, incumbents' claim that TELRIC rates will strand billions of dollars of historical costs is an *empirical* assertion that must be proved. The FCC, however, expressly found that TELRIC prices "may be higher or lower than historical embedded costs," *Local Competition Order* ¶ 705 (JA 398-99), and it determined that the record "does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements" at TELRIC rates. *Id.* ¶ 707 (JA 400-01). Nothing in the record calls the reasonableness of that judgment into question.

First, there are no actual TELRIC-generated rates in the record: the incumbents challenge only the FCC's pricing rules, and those rules indisputably do not set rates.[15] State commissions, not the FCC, establish the actual rates new entrants must pay incumbents to lease network elements. 47 U.S.C. § 252(d)(1). In so doing, they set the depreciation schedules and cost of capital, and the FCC has instructed that these inputs take account of the increasing rate of technological change and the increased risks to incumbents in a competitive

[15]The only rates in the record are the now-invalidated "proxy prices," which never took effect and which the FCC stated may not reliably predict TELRIC rates. *See Local Competition Order* (statement of Commissioner Chong) (state commission may "set a specific rate that is *either above or below* the default proxy ceiling or range") (emphasis added) (JA 448).

environment. *See Local Competition Order* ¶¶ 686, 702 (JA 384-85, 395-96). Such adjustments (which increase the rates new entrants must pay) should compensate incumbents for the costs they claim will be stranded. In any event, without actual TELRIC rates to compare to historical costs it is impossible to determine whether TELRIC will "strand" costs.[16]

Second, the record contains no evidence of incumbents' historical costs – much less their prudently incurred costs on an element-by-element basis – even though such evidence is critical to any claim that the FCC's TELRIC rates for particular elements will strand costs. Nor are these costs readily available. Because state and federal regulators have employed price cap regulation for many years, they have not scrutinized the incumbents' costs to determine whether they have been prudently incurred. There is ample reason to believe these book costs are inflated, *see infra* at 44-45, and thus a full-blown inquiry would be necessary to determine the incumbents' prudently incurred costs.

Third, there is no evidence in the record regarding the extent of element leasing by competitors – either actual or predicted. This omission is particularly noteworthy because the available evidence reveals that few competitors have entered local markets in the five years since the FCC issued the *Local Competition Order*, and fewer still have done so by leasing network elements. *See supra* at 11-12. Because they continue to control more than 92% of the market, the incumbents continue to recover the historical costs on their books through the retail rates they charge their customers. By the time

[16]The incumbents have had ample opportunity to prove their theory in concrete settings. The 1996 Act requires state utility commissions to set actual rates using TELRIC, and provides for federal district court review of those rates. § 252(e)(6). In the dozens of federal court challenges brought pursuant to that provision, the incumbents have seldom even raised Takings claims, and have never established any empirical foundation for such claims.

competitors make sufficient inroads using unbundled elements, the incumbents are likely to have recovered the vast majority of the undepreciated historical costs extant in 1996 through those retail rates. Thus, even if TELRIC rates were shown to be lower than historical cost rates, there is no reason to think (and nothing in the record to show) that significant stranded costs would result. That is precisely what the FCC predicted in 1996. *See Local Competition Order* ¶ 688 (JA 385-86).

Incumbents urge this Court to dispense with the usual requirements of proof because "[t]he FCC fully understood that TELRIC rates would be below historical costs"; that, incumbents argue, "was the intent of TELRIC," as well as "its inexorable effect." ILEC Br. at 28; *see also id.* at 39-40. But the *Local Competition Order* expressly reached the opposite conclusion (¶¶ 705, 707 (JA 398-401)), and for good reason. Although some elements of the telephone network – such as switches and other computer-based elements – may have forward-looking costs that are below historical costs, that is not true for many elements. Buildings, land, lines, and poles, for example, whose prices depend primarily on materials or labor rather than technology, often have forward-looking costs above historical costs. *See, e.g., In re Determining Costs for Universal Service*, Docket No. UT-980311, at 41, 1998 WL 1031919, at * 17 (Wash. Utils. Transp. Comm'n Nov. 20, 1998) ("[A]s GTE witness Calnon points out, the current cost of placing a cable is frequently greater than the embedded cost of placing a cable.").

Nor is it true that TELRIC in particular will inevitably result in rates below historical costs. In the universal service context, the FCC's TELRIC model – which calculates federal subsidies to support interstate service in high cost areas – generated rates that are in many cases higher than the incumbents' historical costs. *See In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14

F.C.C.R. 20156, ¶ 27 (1999). Several state commissions have likewise found in arbitration proceedings that the TELRIC rates exceeded the incumbents' historical cost.[17] Indeed, in such proceedings, incumbents have (when it suits their purpose) denied that there is any relevant difference between TELRIC and embedded cost methodologies.[18]

Similarly unpersuasive are the isolated outside-the-record "facts" that incumbents offer up. The incumbents seek to bolster their takings claim by suggesting, for example, that their network cost approximately $342 billion, and that TELRIC's valuation of $180 billion is thus absurdly low. ILEC Br. at 10-11. But the number the incumbents cite is an *undepreciated* number. Using the same data reported by the incumbents, the depreciated book value of the incumbents' network is not $342

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[17] *In re Qwest Corp.*, No. RPCC-00-1 at 29, 2001 WL 96396, at *14 (Iowa Utils. Bd. Jan. 11, 2001) ("Even Qwest admits its embedded costs are lower than forward-looking in Iowa; a Qwest witness offered testimony the embedded cost of a loop is $17, lower than the statewide average UNE loop price of $20.15."); *In re Determination of the Cost of Basic Local Telecommunications Service*, No. 980696-TP at 10, 1999 WL 112536, at *2 (Fla. Pub. Serv. Comm'n Jan. 7, 1999) (concluding that, in some circumstances, "[t]he embedded cost methodology produces a lower cost for basic local service than the outputs of the models").

[18] *In re AT&T Communications of New York, Inc.*, No. 95-C-657, at 109, 177 P.U.R. 4th 110, 1997 WL 244288 (N.Y. Pub. Serv. Comm'n Apr. 1, 1997) (noting that New York Telephone does not "see any significance in comparisons between TELRIC costs and embedded costs, noting the FCC's explicit recognition that they may differ and that, in some instances, TELRIC costs may be higher than embedded"); *In re U S West Communications, Inc.*, 179 P.U.R. 4th 597, 1997 WL 651428 (Idaho Pub. Utils. Comm'n Aug. 12, 1997) (noting that U S West defended the use of an embedded cost study model by "insist[ing] that the intervenors presented no evidence that forward-looking costs 'differ as a practical matter from the embedded costs used by U S West and Staff'") (quoting U S WEST briefs).

billion but rather $166 billion.[19] Thus, far from showing that TELRIC is confiscatory, the incumbents' own gross figures demonstrate that TELRIC captures the value of incumbents' network. Moreover, even the incumbents' depreciated book value is a number without significance here. It is based on the incumbents' own untested representations of their historical costs and does not even purport to assess what portion of those costs were "prudently incurred." It thus does not correct either for the existence of "phantom assets" that regulators have discovered on incumbents' books or for "gold-plating" that regularly occurred under a rate-of-return regime. Finally, the TELRIC model the incumbents cite is designed for universal service, not for element pricing. The FCC has explicitly stated that the model – which does not include costs for all of the equipment necessary to provide unbundled elements – should not be used "for other purposes, such as determining prices for unbundled network elements," and it has "caution[ed] parties from making any claims in other proceedings based upon the input values [the FCC] adopt[ed]" in developing that model.[20]

Incumbents offer up similar scraps of evidence – such as two self-serving affidavits of GTE marketing employees, *see* ILEC Br. at 10 & nn.4-5 – to suggest that TELRIC rates are 50%-60% of historical cost. *See also id.* at 40 (alleging "massive" discounts). Because the incumbents present their numbers for the first time in this Court, they have not been tested in agency proceedings. Nevertheless, it is noteworthy that one of the affidavits relates to proxy rates, which never took effect, do not constrain the generation of actual TELRIC

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[19] *See* 1999 Statistics of Communications Common Carriers, at Table 2.9 (Account 350) (rel. Aug. 11, 2000), available at http://www.fcc.gov./bureaus/common-carrier/reports/fcc-state_link/socc/99s0cc.pdf.

[20] *In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 F.C.C.R. 20156, ¶ 32 (1999).

rates, and thus are a red herring, and the other affidavit was drawn from a proceeding in which GTE's own cost model "was labeled a 'black box' because its operation and assumptions could not be tested or effectively challenged by others." *GTE South*, 6 F. Supp. 2d at 527. Moreover, the suggestion that TELRIC rates are always 50% or more below historical cost is belied by the incumbents' own conduct. If TELRIC rates presented the opportunity the incumbents posit, the incumbents themselves would have pounced on that opportunity to lease each other's facilities and compete on each other's home turf. Their failure to do so speaks volumes.

In short, there is no support for the incumbents' central claim that TELRIC will result in massive unrecovered costs.

2. *The FCC's supplemental mechanism to consider stranded cost issues eliminates any Takings concerns.*

Even if the incumbents had shown that TELRIC risked stranding significant investment (and even if that were the relevant constitutional test), the *Local Competition Order* would have to be upheld. The FCC has consistently offered the incumbents an opportunity to prove their stranded costs and seek compensation, *e.g.*, *Local Competition Order* ¶ 739 (JA 422), and the incumbents have consistently failed to take advantage of that opportunity. The Constitution requires no more. *See Permian Basin*, 390 U.S. at 770-71 (rejecting challenge to methodology in part because of a procedure for seeking relief from the order); *Williamson County Reg'l Planning Comm'n v. Hamilton Bank of Johnson City*, 473 U.S. 172, 194 (1985); *see also Eastern Enterprises v. Apfel*, 524 U.S. 498, 545 (1998) (Kennedy, J., concurring) ("The Clause operates as a conditional limitation, permitting the government to do what it wants so long as it pays the charge.").

In *Permian Basin*, the Federal Power Commission ("FPC") set interstate rates using maximum "area rates" rather than

developing individual rates based on each producer's costs. The FPC indicated that it might in exceptional circumstances provide "appropriate relief," including an exception to the maximum rates, if an individual producer could show that its out-of-pocket expenses exceeded its revenues. 390 U.S. at 770-71. The FPC noted, however, that it would not stay enforcement of the area rates pending disposition of the petitions for special relief. The Court of Appeals (previewing incumbents' claim here) held that this escape valve was "inadequate" and "vague," and it ordered the FPC to produce definite guidelines that would allow resolution of the producers claims *before* the general rate order went into effect. *Id.* at 771.

This Court reversed, holding that the FPC "was not obliged to delay area regulation until such guidelines could be properly drawn." *Id.* at 772. The Court also noted that, particularly in light of the "still experimental" nature of the terms and consequences of the FPC's ratemaking approach, the FPC "quite reasonably believed that the terms of any exceptional relief should be developed as its experience with area regulation lengthens." *Id.* at 771-72. The Court specifically refused to hold that "the Commission's broad guarantees of special relief were inadequate or excessively imprecise." *Id.* at 772. Thus, *Permian Basin* makes clear that the incumbents have all the protection to which the Fifth Amendment entitles them.

B. The Incumbents Have Not Shown That the Total Effect of TELRIC Will Be Confiscatory.

Under settled case law, the incumbents could not prevail even if they had shown that TELRIC rates for network elements would strand costs associated with those elements. Such evidence is only the start, not the end, of any takings analysis. Even when there are stranded costs, a rate order is constitutional if the "total effect" of that order allows the company "to operate successfully, to maintain its financial integrity, to attract capital,

and to compensate its investors for the risk assumed." *Hope*, 320 U.S. at 605; *see also Duquesne*, 488 U.S. at 312.

In this case, as in *Duquesne* and *Hope*, the incumbents have not even tried to show that the FCC's actions have threatened incumbents' financial integrity or their ability to attract capital. Nor could they, given the market for incumbents' stock and their profitability. "Silence may sometimes be deafening." *Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1264-65 (D.C. Cir. 1993) (describing failure of incumbent telephone company to submit evidence of any steep decline in share prices to support its contention that FCC rates did not adequately compensate investors).

The incumbents seek to avoid the total effects test by narrowing its scope, contending that the Court must evaluate element leasing as though it were a stand-alone operation. *See* ILEC Br. at 35. That argument, however, is contrary to abundant case law holding that a regulated firm's loss of money on a small segment of its business is not sufficient to demonstrate a taking absent a loss to the firm's "over-all business." *See Baltimore & Ohio R.R. Co. v. United States*, 345 U.S. 146, 148-50 (1953) ("So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.'"); *Metropolitan Transp. Auth. v. ICC*, 792 F.2d 287, 297 (2d Cir. 1986) ("imposing a ceiling on particular rates is not a taking so long as it does not cause the railroad to lose money on its overall business"); *Indiana Harbor Belt R.R. Co. v. United States*, 510 F.2d 644, 650 (7th Cir. 1975) (rejecting Takings claim because plaintiff "did not make the showing as to its over-all operations which was necessary to enable the court to

consider such a claim").[21] Thus, for example, the state commission in *Duquesne* was not barred from considering other regulated revenues even though it allowed no return at all on prudently incurred costs in certain nuclear power plants. And it has never been thought a taking that incumbents must serve high cost rural customers at rates alleged to be below cost, because incumbents were also able to serve low cost customers at inflated rates.

Brooks-Scanlon Co. v. Railroad Commission, 251 U.S. 396 (1920), is not to the contrary. At a minimum, nothing in that decision prohibits including other *regulated* revenues that incumbents receive – including, for example, revenues from access charges and federally-tariffed access facilities; yet the incumbents have offered no evidence to suggest that their revenues on FCC-regulated services – much less their overall regulated revenues – fail to provide a constitutionally adequate return. Moreover, nothing in *Brooks-Scanlon* addresses the present situation, in which the same law that allegedly causes a Taking also makes available substantial new sources of revenue. The same integrated legislative scheme that required the incumbents to lease portions of their networks at "just and reasonable" rates also allowed the incumbents for the first time to enter long distance and other markets that the AT&T consent decree had foreclosed. It would defy common sense and precedent to allow incumbents to challenge a law's alleged burdens without considering its undisputed benefits.[22]

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[21] *Cf. American Trucking Ass'n v. United States*, 355 U.S. 141, 153-54 (1957) ("economic justification for carrying on a costly peddle operation depends on combining it with a more lucrative truckload operation").

[22] *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930), and related cases are inapposite. They merely directed the separation of rate bases into interstate and intrastate pools pursuant to the divided regulatory authority existing before the 1996 Act. Nothing in those cases prohibits consideration of revenues from retail rates within the interstate jurisdiction. In the approach established by the FCC, it is state regulators that set the cost of capital, the depreciation rate, and other critical inputs to the compensation process. The returns from other state-regulated operations using the same facilities that are the subject of the Act's unbundling requirements thus must be included in any evaluation of the "total effect" of the regulatory scheme.

C. There Has Not Been an Unconstitutional "Switch" in Methodologies.

Having failed to build a record at the agency to demonstrate either that the total effect of the FCC's actions will be confiscatory or even that those actions will result in significant stranded costs, the incumbents propose a new constitutional rule to justify their policy preference: they assert that the Just Compensation Clause limits the ability of regulators to "switch" methodologies. ILEC Br. at 27. Incumbents contend such a rule is needed to shield investors from regulatory changes they might not have anticipated.

This argument is meritless. To begin with, it makes little sense to describe the FCC's choice of TELRIC as a "switch in methodologies" (*id.*) that violated existing expectations. In the 1996 Act, Congress created a new federal right allowing competitors in the local market to lease unbundled network elements from incumbents. The right to lease at TELRIC rates is thus not the result of a shift in the ratemaking formula for the retail rates charged to local customers, but the consequence of an entirely new set of federal rights and obligations at the wholesale level. Additionally, the regulatory regime on which the incumbents' expectations purportedly rest was the old monopoly rate-of-return regime administered by the States. Even with respect to that regime, however, the incumbents nowhere point to any explicit promise by regulators

guaranteeing a return on prudently incurred costs.[23] To the extent that incumbents allege violation of a promise that was implicit, that promise was one made by States, not the FCC. Indeed, prior to the 1996 Act the FCC did not even have jurisdiction over intrastate rates.

The incumbents' argument thus amounts to the following proposition: because *States* implicitly promised that investors would recover prudently incurred costs used to serve *retail* customers, the *FCC* is prohibited from relying on forward-looking costs when it prescribes a method for setting *wholesale* rates for the first time. No case from this Court remotely stands for that remarkable proposition. To the contrary, this Court has repeatedly upheld "switches" in methodologies, including ones that failed to guarantee recovery of costs recoverable under the old regime. Thus no investor could have reasonably believed that federal regulators had guaranteed a return under the regulatory framework in effect at the time of investment. Any doubt should have been conclusively dispelled by the progression from monopoly to competition that had occurred in the telecommunications industry over the past fifty years and that had been signaled for local markets for a decade or more.

1. Nothing in this Court's jurisprudence precludes or limits a one-time switch in methodologies.

Even if the FCC's adoption of TELRIC were considered a "switch," there is no support in this Court's jurisprudence for the proposition that the Just Compensation Clause forbids regulators from switching methodologies whenever the switch

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[23]The absence of any explicit promise alone is sufficient to defeat any "regulatory compact" claim. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1010-11 (1984). That is perhaps why the incumbents allude to, but decline to rely on, this Court's regulatory compact cases. *See* ILEC Br. at 30.

would deny full recovery of costs identified under the previous methodology. To the contrary, fundamental changes in rate-setting methodology have routinely been upheld without any special scrutiny.

In *Wisconsin v. FPC*, the FPC declared its intention to switch from an "individual company cost of service method, based on theories of original cost and prudent investment" to an approach under which rates would be established "on an area basis, rather than on an individual company basis." 373 U.S. at 298-99. As a result, individual producers with above-average costs might not recover all their costs. This Court nevertheless rejected efforts – much like the ones incumbents have made here – to invalidate that switch even before rates were set, noting that "we cannot say that the rates to be developed in these proceedings will in all likelihood be so high as to deprive consumers, or so low as to deprive producers, of their right to a just and reasonable rate." *Id.* at 310.

In *Permian Basin*, natural gas producers brought a similar constitutional challenge to the same "area rate approach" after the area rates were set. The FPC's implementation of the area rate approach included a safety valve that ensured recovery of certain "operating expenses"; the FPC explicitly noted, however, that a producer's inability to recover its "unsuccessful exploration costs" – even if prudently incurred – would not alone warrant relief. Despite this clear indication that individual producers might not recover all historical costs or even all prudently incurred costs (as they would have under the old regime), the Court upheld the rate order in its entirety.

And in *Duquesne*, this Court upheld a Pennsylvania statute that switched methodologies to preclude the recovery of investments that were not used and useful, even though those investments had been prudently incurred and would have been recoverable under the old regime. Indeed, since *Hope*, this

Court has *never* struck down a rate or ratemaking methodology on the ground that it was a switch from a prior methodology.

Remarkably, the incumbents purport to rely on *Duquesne*. But *Duquesne* quite clearly held that a regulator has considerable freedom to switch rate-setting methodologies even if the switch would "strand" costs recovered under the previous approach. *Duquesne* was quite careful to note (in limited *dicta*) that it is not a single switch, but only a decision "to *arbitrarily* switch back and forth between methodologies" that even arguably raises "constitutional questions." *Wisconsin v. FPC*, 373 U.S. at 315 (emphasis added). *Duquesne*'s focus on arbitrariness was no accident. Arbitrarily switching back and forth between methodologies gives rise to the concern that rates are being set opportunistically to the detriment of utilities (without any valid public policy basis), forcing them to "bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Id.* But it is a far different manner when regulators change methods in pursuit of legitimate public policy objectives, or based on practical assessments of the relative merits of one regulatory tool over another. *See, e.g., id.* at 298-99 (switching methodologies because the old methodology "gave rise to staggering cost allocation problems," resulted in "widely varying prices for gas from a single field," and created an "intolerable administrative burden"). To view with hostility any change in methodologies would be to deprive state and federal policymakers of the flexibility *Duquesne* specifically sought to preserve.

Nor are the incumbents helped by the observation in *Duquesne* that the rates set by the Pennsylvania PUC provided an adequate return even under the old rate base. The Court never suggested that this comparison, which was essentially a "sanity check" on the new approach, was a constitutional requirement. Indeed, such a conclusion would be flatly contrary to the remainder of the opinion, which not only limited

constitutional concerns to situations in which regulators *arbitrarily* switch back and forth, but also emphasized the methodological freedom possessed by regulators and refused to enshrine prudently incurred costs as a constitutional baseline.

The instant case illustrates the wisdom of *Duquesne*. The FCC adopted TELRIC because it was the methodology best suited to advancing the 1996 Act's goal of bringing competition to local markets, and because there was no reason to think it would have harsh results. Although rapid technological change has driven down the forward-looking cost of computer-based elements, elements whose cost depends on labor and materials are generally more expensive than they used to be. *See Local Competition Order* ¶ 705 (JA 398-99). There is thus no reason to deny the FCC the option of using TELRIC. Moreover, regulatory flexibility is particularly critical in telecommunications, where methods of competition, modes of communication, and whole sectors of the industry exist today that were unimaginable decades earlier. Congress, state regulators, and the FCC have always had, and must continue to have, discretion – except "at the margins" – to adapt to those changes. Nothing in Constitution requires a different result.

2. *The "shift" in methodologies did not upset reasonable investor expectations or otherwise treat investors unfairly.*

Even if all that were not so, the underpinning for the incumbents' proposed bar on methodological change – that it is unfair to investors – lacks merit. According to incumbents, the FCC's "abrupt shift" to TELRIC surprised reasonable investors, effectively "rewriting the terms of thousands of regulatory transactions closed long ago," and "eliminat[ing] the basis on which private parties have relied in making substantial investment." ILEC Br. at 29-30.

In truth, the 1996 Act was a surprise to no one. States had been trying to introduce competition to local markets for years by requiring unbundling at rates based on forward-looking costs. With the former monopolistic long distance and equipment markets fully open to competition and the consensus building to open local markets, no reasonable investor could have expected that the FCC or the state commissions would guarantee recovery of all prudently incurred costs.

Similarly belied by the record is the suggestion that the 1996 Act rewrote transactions "closed long ago." ILEC Br. at 30. At the time of the FCC proceedings, over 50% of the incumbents' plant had been acquired in the 1990s, when no reasonable investor could have believed that the local monopoly would be forever sheltered from competition, *see* Affidavit of Lee L. Selwin and Patricia D. Kravtin, ¶ 5 (attached to AT&T Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996)) (JA 149-51), *see also*, Supp. Lodging, and incumbents were replacing older plant at the rate of 5-10% per year. *Id.* The vast majority of incumbents' investment, therefore, occurred when an expectation of guaranteed recovery of all prudently incurred costs was patently unreasonable.

The terms of the 1996 Act further refute any claims of unfairness to investors. The FCC's adoption of TELRIC occurred as part of a broader reallocation of benefits and burdens that occurred as part of the 1996 Act. The Act relieved the incumbents of the various consent decrees to which they were subject and opened vast new markets – such as the long distance markets – that incumbents have entered aggressively. *See supra* at 7-8, 12. Equally critical are the benefits bestowed by the local competition provisions themselves, which permit incumbents, as potential competitors in local markets outside their home regions, to benefit from the same "unconstitutional" rate regime of which they complain. In assessing the 1996

Act's effect on investor expectations, these many benefits cannot be ignored.

More broadly, absent an explicit promise that incumbents nowhere assert, investors could not have expected that they would be immune from regulatory change or the introduction of competition. This Court has consistently rejected the notion that investors have a constitutional right to a guaranteed return on historical costs. *See, e.g.*, *Market Street Ry. Co. v. Railroad Comm'n*, 324 U.S. 548, 566 (1945) ("[R]egulation does not assure that the regulated business make a profit."); *Hope*, 320 U.S. at 603 ("[R]egulation does not insure that the business shall produce net revenues.") (internal citation and quotation omitted). Instead, regulated entities have a right only to a rate that ensures their fiscal integrity and allows them to attract capital, and investors can reasonably expect no more.

Finally, incumbents' arguments suffer from a more fundamental failing: if investors' expectations of guaranteed return on investment have been upset, it is the decision to introduce competition, not the FCC's pricing decisions, that has upset them. A firm facing competition surely has no guarantee that it will recover its historical costs. If incumbents are correct that investors reasonably expected a guaranteed return on their investment, then the introduction of competition itself violates the Constitution. Given that the interests of investors have never been the sole concern of the Just Compensation Clause, *see, e.g. Hope*, 320 U.S. at 603 (fixing rates "involves a balancing of the investor and the consumer interests"); *FCC v. Florida Power Corp.*, 480 U.S. 245, 253 (1987) ("investors' interests provide only one of the variables in the constitutional calculus of reasonableness") (internal citation and quotation omitted), this Court should hesitate before embracing such a significant limitation on state and congressional power to experiment with deregulation.

D. Prudently Incurred Cost Has Never Been, and Should Not Now Become, the Constitutional Benchmark.

Because their other arguments lack merit, the incumbents ultimately can prevail only if this Court does what it has refused to do for more than a Century: enshrine the prudent cost methodology as a constitutional requirement. Although the incumbents' failure to present evidence renders this issue purely academic (*see* Point II.A), the imposition of prudently incurred cost as the constitutional standard would be entirely "unwarranted." *Duquesne*, 488 U.S. at 315. In every other area of Takings law, it is value, not historical cost or prudently incurred cost, that is the constitutional touchstone. Thus, a methodology that gives the incumbents the value of the elements leased – which TELRIC surely does[24] – is constitutional. And incumbents' principal arguments for a prudent cost approach – that it is less manipulable and more practical – are myths.

Elevating prudently incurred costs to the status of a constitutional benchmark would effect a radical restructuring of Takings law, placing investors in public utilities in a privileged position occupied by no other property owners. It is settled outside of ratemaking that the owner of property is entitled only to "the market value" of the property at the time of the Taking, *Olson v. United States*, 292 U.S. 246, 255 (1934); *see also United States v. Miller*, 317 U.S. 369, 374 (1943), even if that value is less than the owner's investment in the property, *see* 292 U.S. at 255 (market value "may be more or less than the

[24] Forward-looking cost methodologies such as TELRIC are accepted methods for valuing property. In a competitive market, a buyer would never pay more for an asset than the cost of building a functional substitute for it. By measuring what it costs now to replace the functionality of the existing network, TELRIC "mimics the operation of the competitive market," *Duquesne*, 488 U.S. at 308, and thus captures the full value of that network.

owner's investment," and the "return yielded may have been greater or less than interest, taxes, and other carrying charges"). The Fifth Amendment "does not guarantee [a property owner] a return of his investment," *United States ex rel. Tennessee Valley Authority v. Powelson*, 319 U.S. 266, 285 (1943), because "[i]t is the property and not the cost of it that is safeguarded by state and Federal Constitutions." *Olson*, 292 U.S. at 255.

Until now, this Court has consistently reaffirmed that, in ratemaking cases, the Constitution does not require recovery of historical cost, or even recovery of prudently incurred cost, and that compensation based on the value of the assets is permissible. *See Duquesne*, 488 U.S. at 308 (*quoting Smyth v. Ames*, 169 U.S. 466, 547 (1898)). Indeed, prior to *Hope*, the Court consistently rejected efforts to allow regulators to use historical costs as the sole measure of constitutionally adequate compensation. *See, e.g., Southwestern Bell Tel. Co.*, 262 U.S. at 289-90 (Brandeis, J. concurring); *see generally Duquesne*, 488 U.S. at 308-09.

Since *Hope*, this Court has repeatedly approved methodologies that measure the value of the assets, *see, e.g., Duquesne* 308-09 (approving a methodology under which "[t]o the extent utilities' investments turn out to be bad ones, . . . the investments have no fair value and so justify no return); *Market Street Ry.*, 324 U.S. at 564-67 (affirming rates based on present value of company's assets and thus affirming write off of more than *two-thirds* of company's historical investments); *Mobil Oil*, 498 U.S. at 219 (affirming approach that "approximated the replacement cost of gas based upon the current cost of finding new gas fields, drilling new wells, and producing new gas"), and has approved methodologies that explicitly declined to cover the prudently incurred costs of property-owners. *See Permian Basin*, 390 U.S. at 769-71 (approving area rate methodology designed to meet the average costs rather than

individual costs and that explicitly refused to provide recovery for unsuccessful exploration costs, even if prudently incurred).

The case for enshrining prudent cost as the constitutional standard is startlingly weak. Incumbents suggest first that prudential cost methodologies are less manipulable than forward-looking value-based methodologies. Accurate historical costs of even the total network, however, cannot simply be read from a book or easily and objectively determined. *See* Michael K. Kellogg, *et al.*, *Federal Telecommunications Law* § 9.8, at 477 (1992) ("We now know that by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction."). Indeed, an FCC audit found that incumbents' books, which would be the basis for historical cost analysis, are filled with "phantom assets" whose existence cannot be verified. *See, e.g.*, *FCC Releases Audit Reports on RBOCs' Property Records*, Report No. CC99-3, 1999 WL 95044 (FCC Feb. 25, 1999) (FCC audit comparing book entries for $47 billion in assets with actual assets revealed that incumbents' "book costs may be overstated by approximately $5 billion"). As Justice Jackson observed, "[t]o make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates. . . . However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive." *Hope*, 320 U.S. at 644 n.40 (Jackson, J., dissenting).

Nor is the assessment whether costs have been prudently incurred a simple one. The traditional regime of monopoly rate-of-return regulation created substantial incentives for incumbents to overinvest in, or "gold-plate" their networks by building facilities not needed to provide local service. *See* Kellogg, *supra*, at 478. Although regulators scrutinize

incumbents' investments, overinvestment is frequently impossible to pinpoint. *See* Harvey Averch & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 5 Am. Econ. Rev. 1052, 1062-63 (1962). Moreover, even if prudently incurred costs could be determined, there is no way other than through economic modeling to assign those costs to particular elements in particular locations because the incumbents' books are not kept on an element-by-element basis. There is no reason to believe that this allocation process is any more objective or less difficult in a prudent cost regime than it is in a forward-looking cost regime. A forward-looking cost approach has the advantage that the starting point for the cost allocations are open for all parties to review.

Nor can any practical problems of calculating the value of utility property justify imposition of a prudent cost rule as a requirement of the Constitution or preclude reliance on a TELRIC methodology. Advances in economic modeling, now a routine aspect of rate regulation, permit the measurement of forward-looking costs with unprecedented accuracy. *See generally American Pub. Gas Ass'n v. FPC*, 567 F.2d 1016, 1036-37 (D.C. Cir. 1977). That is why, by 1996, forward-looking methodologies such as TELRIC were being used successfully by state regulators and by regulators abroad in analogous contexts, *see Local Competition Order* ¶ 631 (JA 334); *supra* at 5-6, 17-19; *Duquesne*, 488 U.S. at 316 n.10, and that is why at least 35 States independently adopted TELRIC (or similar) methodologies during the two-year period in which the FCC's TELRIC rules were stayed. *See supra* at 18 n.13.

Further, the history of this Court's ratemaking jurisprudence teaches that the alleged impracticality of one approach provides a shaky foundation for establishing another as the fixed constitutional standard. *Cf. Southwestern Bell Tel. Co.*, 262 U.S. at 309 (Brandeis, J., concurring) (noting a historical cost approach, which was "impossible" thirty years

earlier, had become "feasible"). As TELRIC itself demonstrates, refinements in economic modeling and advances in computing have made practical today what may have seemed impractical in 1923. Concerns over impracticality, while relevant policy considerations, do not justify enshrining one methodology as required (or forbidden) by the Constitution.

E. The Doctrine of Constitutional Avoidance Has No Application Here.

The incumbents' arguments fare no better dressed up in the garb of constitutional avoidance. That doctrine has extremely limited application in Just Compensation cases generally, and has no application here.

Hope and *Duquesne* foreclose the argument that a regulator lacks flexibility to choose a particular ratemaking methodology on the basis of a speculative assertion that the methodology might result in confiscatory rates. The proposition that the Constitution does not impose any particular methodology would be meaningless if the mere allegation that a particular methodology (or switch in methodologies) might raise a Takings claim would prohibit the use of that method. The incumbents' argument is also irreconcilable with the Court's refusal to use analogous avoidance arguments to construe the term "just and reasonable" to require a particular methodology, even following a "switch" that did not guarantee recovery of costs. *See, e.g., Wisconsin v. FPC*, 373 U.S. at 309.

Riverside Bayview similarly refutes incumbents' argument. In that case, the Court rejected a Takings-based avoidance claim, holding that "the possibility that the application of a regulatory program may in some instances result in the taking of individual pieces of property is no justification for the use of narrowing constructions to curtail the program if compensation will in any event be available in those cases where a Taking has occurred. Under such circumstances, adoption of a narrowing

construction does not constitute avoidance of a constitutional difficulty; it merely frustrates permissible applications of a statute or regulation." 474 U.S. at 128 (internal citation and quotation omitted).

The doctrine of constitutional avoidance must be sparingly applied in the takings context, because the Just Compensation Clause "is designed not to limit the governmental interference with property rights per se, but rather to secure compensation in the event of otherwise proper interference amounting to a taking." *Eastern Enters.*, 524 U.S. at 545 (Kennedy, J., concurring) (internal citation and quotation omitted); *see also Williamson County*, 473 U.S. at 193. Aggressive application of the doctrine would effectively prohibit government action even though the Clause itself would undoubtedly permit that action as long as a payment mechanism is available. Here, such a mechanism is available at the FCC. *See supra* at 10, 31.

III. THE FCC'S CHOICE OF TELRIC WAS NOT ARBITRARY OR CAPRICIOUS.

Lacking any serious textual or constitutional argument, the incumbent LECs close with a smorgasbord of administrative law challenges to the reasonableness of the FCC's decision to adopt TELRIC. In assessing these claims, the relevant inquiry is not whether this Court would have reached the same judgment had it decided the issue in the first instance, because a reviewing court "is not empowered to substitute its judgment for that of the agency." *Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 285 (1974) (internal citation and quotation omitted). That is particularly true where, as here, the matter is at the heart of the agency's technical expertise and requires predictive judgments. If the agency has "drawn out and crystalized [the] competing interests [presented and] attempted to judge them with as much delicacy as the prospective nature of the inquiry permits, . . . [the court]

can require no more." *Id.* at 293-94 (quotation omitted). The *Local Competition Order* contains no "clear error of judgment," *id.* at 285, and thus easily survives review.

The incumbents first assert that TELRIC was an arbitrary policy choice because it amounted to an unexplained departure from the FCC's prior consistent commitment to historical cost rate-setting. That charge is baseless. The FCC had departed from historical cost methods more than a decade before when it introduced price caps based on the perceived shortcomings of historical cost ratemaking. *See* WorldCom Br. at 8. Moreover, the FCC could not have departed from prior policy in implementing §§ 251 and 252 because the *Local Competition Order* was the FCC's first word on the subject. The *Order* addressed a new issue on which the FCC had never previously spoken. That the FCC had used historical cost ratemaking to implement the pricing provisions of the 1992 Cable Act is beside the point. That was an entirely different statute addressing an entirely different market that remained in a monopoly state.

Nor can the FCC credibly be faulted for failing to explain its choice of TELRIC over competing options presented to it. A full 244 paragraphs of the *Local Competition Order* are devoted to justifying the choice of TELRIC and, in particular, to explaining why it best implements the 1996 Act's goal of opening local markets to competition. *Local Competition Order* ¶ 679 (JA 379-80). The *Order* expressly considers and rejects all alternative pricing approaches proposed in the comments. Thus, for example, the FCC rejected a "replication cost" approach on the ground that it would distort the rates consumers pay for telephone service. *See id.* ¶ 684 (JA 383). The FCC likewise rejected a historical cost methodology on the grounds that it would reward past incumbent inefficiency, send the wrong price signals to new entrants, and deny consumers the benefits of competition-based rates. *Id.* ¶¶ 704-711 (JA 397-

403). And the FCC rejected the "efficient component pricing" method ("ECPR") on the grounds that it would (by granting incumbents the full measure of profit they would otherwise lose to competition) inappropriately inflate costs borne by new entrants. *Id.* ¶¶ 708-711 (JA 401-03); *see also id.* ¶ 662 (JA 368) (discussing comments of Professors Baumol, Ordover, and Willig). The FCC rejected "Ramsey pricing" on the ground that it was particularly ill-suited to the goals of the 1996 Act, *id.* ¶ 696 & n.1700 (JA 390-91), concluding, as have other federal regulators, that the use of Ramsey pricing is also "too difficult and burdensome for universal application" because it requires "the elasticity of demand to be quantified" for every element that will be priced. *See Coal Rate Guidelines*, 1 I.C.C.2d at 527.

Nor was there anything remotely inadequate about the Commission's explanations. The Commission considered and rejected the incumbents' assertion that a forward-looking cost methodology is difficult to administer – based on the experiences of States that had already employed such approaches. *Local Competition Order* ¶¶ 631, 681 (JA 334-36, 381). That judgment is bolstered by the recent experience of States which have, in fact, set rates based on the forward-looking cost models introduced by new entrants and incumbents alike. The FCC's conclusion that the use of historical costs would lead to compensation for significant levels of incumbent inefficiency is equally reasonable. Although regulators *once* tried to scrutinize incumbents' books to determine if their costs were prudently incurred, that enterprise proved so difficult that regulators have generally abandoned that effort and moved to price cap regulation.

The incumbents also find fault with the FCC's conclusion that non-TELRIC prices will lead to inefficient investment decisions. ILEC Br. at 48-49. But the FCC merely indicated, consistent with the weight of economic authority, that even

rational, efficient actors will make choices based on the data and circumstances presented to them. If input costs are not priced at forward-looking, efficient rates, the decisions entrants make will be similarly inefficient. *Local Competition Order* ¶¶ 672, 679, 705 (JA 375, 379, 398). The FCC's decision to encourage efficient investment decisions is plainly rational.

Finally, the incumbents assert that the "FCC ignored the threat" that prices which are set "too low" will discourage facilities-based competition. ILEC Br. at 49. That assertion is simply false. The FCC expressly acknowledged this theoretical possibility, and adjusted its methodology to inflate rates in order to further *encourage* facilities-based entry. *Local Competition Order* ¶ 685 (concluding that building existing inefficiencies into TELRIC would "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent") (JA 383-84). The FCC's conclusion that the particular methodology it adopted best serves the dual policy goals of providing consumers the benefits of competition and encouraging efficient facilities-based entry epitomizes the "rational weighing of competing policies" to which deference is owed. *FCC v. National Citizens Comm. for Broad.*, 436 U.S. 775, 803 (1978).[25]

CONCLUSION

The Eighth Circuit's holding that neither the 1996 Act nor the Constitution prohibits the use of TELRIC's forward-looking methodology should be affirmed.

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[25]The incumbents promise to explain in their response brief their argument that TELRIC incorporates "unrealistic projections." ILEC Br. at 48. WorldCom will thus address that argument in its reply brief. The incumbents also assert that the equities preclude the use of TELRIC because investors assumed that rates would be based on historical cost. *Id.* at 49. As explained, *see supra* at 39-41, that assertion is baseless.

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